INDEPENDENT ENERGY PRODUCERS

Winston Hickox, Chair
Market Advisory Committee
CALEPA

June 15, 2007

RE: IEP Comments on MAC (Draft) Recommendations to CARB

Dear Chair Hickox;

As a complement to IEP's oral comments to the Market Advisory Committee (MAC) on June 12, 2007, and in response to specific comments posed by committee members, IEP provides these comments to the MAC for its consideration as it finalizes its Recommendations to the California Air Resources Board (CARB).

As an overview, IEP supports the MAC Draft Recommendations general design principals [Draft Recommendations, at p. 18]. We are particularly supportive of the three design principles that most affect the "points of regulation", i.e. cost-effectiveness, fairness, and simplicity. These principles should apply broadly as the MAC (and the CARB) moves forward on the actual design of the overall GHG emission reduction program under AB 32. In addition, IEP supports the MAC's focus and concern regarding "leakage" which can occur when in-state generators are treated in a different manner than out-of-state generators exporting power into California.

Provided below are some initial thoughts related to the MAC Draft Recommendations.

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A. 1st Seller/Load-based and Commerce Clause Certainty

The MAC is recommending placing the legal obligation on the first seller of power into California electricity markets. As IEP understands the 1st Seller approach, the focus is on "sellers" and includes sellers of power into California at *wholesale*. Generally, when considering the electric sector, sales at wholesale are subject to the Federal Power Act and the Interstate Commerce Clause.

The MAC Draft Recommendations state: "The load-based approach is consistent in its treatment of imports vs. domestically generated power insofar as both are regulated at the LSE, whereas the first seller approach is consistent in regulating the entity that first sells power into California's electricity system, no matter where the power originated." Thus, the MAC concludes, "Therefore, the Committee believes either approach, …., can be designed to be consistent with the Interstate Commerce Clause." [MAC Draft Recommendations, at p. 42][1]

The MAC Committee apparently reviewed a range of legal opinions/analyses related to this issue. The Draft Recommendations further suggest that these legal analyses raise no significant legal concerns related to the Commerce Clause. IEP member companies are seeking regulatory certainty as the state moves forward in designing and implementing its GHG program. Regulatory certainty is important, given the significant investment in new generation (and transmission) infrastructure needed in California

[1] Generally, a load-based approach (i.e. a LSE-based approach)[1] focuses on regulating the procurement decisions of the LSE by regulating its *retail sales*.

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on a going-forward basis. Thus, we have concerns regarding the potential for litigation, particularly over a Commerce Clause claim, which may hinder needed investment in a timely manner. Certainly, developing a cap and trade program upon questionable legal foundations would not be prudent.

IEP recommends that the MAC provide its legal analyses/opinions to the public for its review and consideration. This review will be helpful to allay concerns that the 1st Seller-approach may raise barriers to implementation in the form of Commerce Clause challenges.

B. Complexity of the Electric Sector: Not all Generators are Similarly Situated

When considering the electric sector (e.g. Chapter 5), IEP believes that the MAC may not fully appreciate the fact that not all generators are similarly situated. The distinctions among generators that concern IEP the most are not those that are associated with technology. Rather, we have concerns regarding distinctions based on "ownership-type." Specifically, in California today, approximately 50 percent of the installed generation is owned/operated by independent power producers (IPPs). The other 50 percent is owned by utilities, either investor-owned utilities (regulated by the CPUC) or municipal utilities (regulated by local governing boards). Because all electric generators are not similarly situated in the competitive electric market, a number of key concerns arise regarding design features of a GHG program generally, including cap and trade, and the MAC Draft Recommendations specifically. A couple of key concerns are described below.

i. Potential for Unwarranted Competitive Advantage

IPPs have a sole function in the electric sector: IPPs are suppliers of power. LSEs, on the other hand, may have two functions. One the one hand, LSEs are buyers of wholesale power which they deliver to their retail load. On the other hand, some LSEs (particularly the utilities) seek to build, own, and operate generation. In this latter function, the LSEs are direct competitors of IPPs. This dynamic must be understood when designing a cap/trade program, as the overall design can convey unwarranted competitive advantage to one sector vs. the other based solely on ownership-type. This is not the purpose of AB 32 nor would it be consistent with the MAC's design principles.

ii. Cost Recovery

The MAC Draft Recommendations seemingly fail to appreciate the fact that cost recovery for various groups within the electric sector vary dramatically depending on the ownership. For example, the Draft Recommendations states: "Generators and initial sellers would pass allowance costs to LSEs, which in turn would incorporate these costs in consumer prices." [MAC draft Recommendations, p. 44] However, many IPP generators operating under existing contracts do not have an ability to pass the costs of allowances thru to buyers in a comparable fashion as the utility-owned assets. This distinction could create significant competitive advantage to utility-owned generation.

On the one hand, some *IPPs* operate under power purchase agreements (PPAs) that fix the cost of capacity and define the energy price for an extended period to time. Alternatively, they may operate under natural gas tolling agreements. In both examples, the IPPs are contractually bound to the terms and conditions of the contract. If the obligation to secure allowances were imposed on them, they would have no means to recover the costs of allowances under the existing terms of the contract other than to re-negotiate the contract with the purchaser. As noted above, this typically requires the IPP to re-negotiate with an LSE/utility with whom one may be competing in another context for the opportunity to build new generation. On the other hand, *LSEs such as the utilities* would need only appeal to their regulating bodies for cost recovery of the reasonable costs of securing allowances, and the costs for the purchase of such allowances will typically be treated as a "pass through" via rates to the consumer. Thus, they have a clear means to recover the costs of environmental compliance measures.

At the June 7 MAC meeting, IEP was asked to (1) elaborate on these types of contracts and (2) indicate the extent to which these QF contracts, as amended from time to time, will extend into the 2012 timeframe and beyond.

Regarding the nature of these contracts, Qualifying Facilities (QFs), typically cogenerators and alternative energy providers, have long-term contracts with the utilities. Established pursuant to federal legislation and authority (i.e. PURPA), QFs are entitled to get paid the utilities' "avoided cost" (i.e. that which the utilities would pay but for the presence of the QF). Currently, pursuant to these requirements, in-state QFs hold CPUC-approved contracts. Under these contracts, QF payments are a function of either (a) fixed price for energy and capacity, or (b) a CPUC-approved formula that is a function of avoided capacity (fixed), avoided O&M (fixed), the heat rate of the utilities "avoided unit" (fixed) and a natural gas "fuel component" the price of which is determined by various public indices of the border price of natural gas (variable). Neither of these factors provides the means for the QF to reasonably recover the cost of GHG allowances comparable to other market participants such as the utilities.

Regarding the extent to which IPPs, particularly QFs, are affected by this situation, unfortunately we are unable to provide the MAC with the analysis requested. While aware that many contracts are situated in this manner, we have researched this issue (and requested this information from the utilities in other regulatory arenas): however, the termination dates of QF contracts have been deemed confidential by the utilities. Thus, this information for the entire class of QF generation (approximately 10,000 MWs) is not publicly available. We do believe, however, that the amount of QF contracts extending into 2012 and beyond is significant. Nor do we believe that this concern, namely that contract holders may possess contracts for which they have no meaningful opportunities to recover the costs of GHG compliance, is limited solely to QFs. We have been informed that over 4,000 MWs on non-QF power in CA operate under tolling agreements that create similar barriers to cost recovery. Importantly, what is most notable here is that there exists a sizable subset of generation, not owned by the utilities, that are not similarly situated as the utilities to recover these costs. As a result, depending on how the GHG emission reduction program is implemented and allowances are allocated, the program may have discriminatory affects within the electric sector due primarily to ownership-type rather than technology type. This outcome would not be consistent with the design goal of "fairness" espoused by the MAC.

iii. Dispatch Rights

"Dispatch rights" refer to the right to direct the operations of a generation unit. In many cases, a generator owner may have transferred the dispatch rights to a third-party, e.g. an LSE, so that the operations of the generating unit match more directly the load the LSE is serving. Similarly, most if not all generators operating within the control area of the California Independent System Operator (CAISO) will have executed a Participating Generator Agreement (PGA) that compels the generation facility to operate within the CAISO Tariff. The CAISO Tariff affords the CAISO rights to "call" on specific generation units to ensure, among other things, grid reliability. This essentially transfers to the CAISO the dispatch rights over an individual generating unit in prescribed conditions.

This scenario poses a particular problem when the electric system becomes strained (i.e. the balance between supply and demand is very tight). If a generator has not acquired allowances in advance, and has no means to acquire them in real time when receiving a dispatch order in real time (e.g. from the CAISO), what happens? During the energy crises of 2000/2001, this scenario did arise in relation to the South Coast Reclaim Program wherein generators were being directed to operate but they were not in a position to acquire limited Reclaim Credits. The MAC Draft Recommendations provide for banking, but not borrowing. These recommendations need to be assessed in the context of whether they provide sufficient flexibility to match the real-time operational requirements of generating units that may not have 100% real-time operational control of their units.

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Consistent with the MAC's overall design goals of fairness and simplicity, etc**.,** the MAC must address these "complexities" of the energy sector in its final recommendations. Specifically, ***IEP recommends*** the following:

- Prescribe a clear path to "cost recovery" that doesn't discriminate against one class of generators vs. another from an ownership perspective, and
- Addresses the reality that the operations of specific generators may not rest within the control of the generation owner and, thus, the ability to forecast the need for allowance to ensure grid reliability may be difficult.

C. Allowances: Allocations Principles

If allowances are to be employed as part of a cap and trade (C/T) program, then the MAC must address how to employ allowances consistent with the design principles of fairness, simplicity, and cost-effectiveness. For the competitive electric sector in which IPPs and utilities compete to build generation, allowance allocations become variable operating costs and, thus, have competitive impacts. IEP would be concerned if the allocation of allowances has a discriminatory as to the ownership of generation (as opposed to technology type).

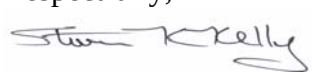
For example, one suggestion presented to the MAC was the concept of freely allocating allowances to the LSEs, which would then presumably sell the allowance to the "point for compliance" (e.g. generators) which must retain them for regulatory purposes. The effect of this approach would be to facilitate a significant "wealth transfer" from one group within the electric sector (i.e.IPPs) to another group (LSEs such as the utilities) with whom they are competing. In addition, allocating allowances freely to LSEs that own generation but not IPPs that own generation could result in the dispatch of higher emitting resources (e.g. LSE generation with "free" allowances) over lower-emitting resources (e.g. IPPs with "purchased allowances"). Outcomes such as these would be counter-productive.

If allowances are to be allocated, ***IEP recommends*** that the MAC consider the following principals related to the allocation of allowances:

- Allowances should be released by the state on behalf of the public as a whole;
- Allowances should be released in a manner that reflects the sectorial contributions to the state's inventory of GHG emissions (e.g. electric sector, transportation sector, refinery sector);
- Allowances should be released in a manner that does not discriminate among generation based on owner-ship type;
- If auctions are employed, …
    - Any such auctions of allowances should be held periodically, in an open and transparent manner, by a single entity;
    - Entities that are the "points of compliance" must have the right and ability to acquire allowances in the initial release; and
    - Revenues from the auction should be managed in a central fund on behalf of the public (e.g. via a Public Trust) to further the purposes of the state's GHG program, particularly investment(s) in competitive, low-emitting/zero-emitting generating resources, consistent with the principles of environmental integrity, cost-effectiveness, fairness, and simplicity.

IEP appreciates the opportunity to provide these comments.

Respectfully,



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